services, which are provided by connecting the BOC's local facilities to wireless facilities.[95] Certain parties in this debate emphasized the anti-competitive dangers that arise if the BOC is permitted to provide such services on a physically integrated basis. That is, they emphasized the dangers that arise if the BOC is allowed to place the design, construction, and operation of the non-local facilities at issue -- such as interLATA facilities in the case of interLATA services, computer facilities in the case of enhanced services, or wireless facilities in the case of wireless services -- in the local operating company. For example, with respect to interLATA services, these parties were concerned that a BOC, if permitted to provide such services on an integrated basis, would have the ability and incentive to arrange more efficiently designed, higher quality connection between its local network and its interLATA facilities than between its local network and rivals' interLATA facilities. They were also concerned that a BOC might take the common costs of the facilities (and employees) that are jointly used to provide both local and interLATA service and allocate, on its books of account, an undue proportion of such costs to its local operations. As suggested above, such improper cost allocation would allow the BOCs to overcharge local service ratepayers while at the same time inefficiently undercut their interexchange competitors. On the other side of the debate, the BOCs emphasized the significant integrative efficiencies that result from being able to have the same facilities (and employees) that are used in the design, construction, and operation of their local networks used in the design, construction, and operation of their interLATA networks. And they also disputed that service on a physically integrated basis raises the anti-competitive dangers described above.[96] The MFJ bar on the provision of interLATA services, which preceded the section 271/272 framework, clearly reflected a judgment that the dangers were serious and outweighed any benefits.

48. There was a related well-known debate during these years over the wisdom of requiring the BOCs, in the event they were to be permitted to provide competitive services that require the BOCs' local facilities as an input for such services, to do so through a

---

subscriber additional, different, or restructured information; or involve subscriber interaction with stored information." 47 C.F.R. §64.702(a).

[95] We note that these competitive activities -- which, by definition, require local BOC facilities as an input to such activities -- may be distinguished from competitive activities that involve connection to local BOC facilities but are nonetheless stand-alone, unbundled offerings. The provision of customer premises equipment is an example.

[96] In more recent years, the BOCs have also argued that even assuming *arguendo* that, at the time of the MFJ, there were legitimate anti-competitive dangers to be considered, any such dangers are no longer serious in light of certain new developments, such as the trend towards pure price cap regulation (which lessens the BOCs' incentive to misallocate costs), increasing regulatory experience with the "equal access" regime initiated by the MFJ (which lessens the BOCs' ability to engage in discrimination without detection), and perhaps most importantly, the opening of the local network to facilities-based competition. As explained below, however, in enacting section 272, Congress clearly concluded that the dangers of anticompetitive conduct, and the need for structural and nonstructural safeguards, will not yet have been eliminated when the BOCs are permitted to enter the in-region long-distance business.

separate affiliate.[97] For certain such services such as wireless services, the Commission decided, precisely because of the anti-competitive dangers described above, that a separate affiliate would generally be required.[98] With respect to the provision of interLATA services on a non-dominant basis by local exchange carriers other than the BOCs (which were not covered by the MFJ), the Commission decided the same.[99] For other services such as enhanced services, the Commission originally determined that a separate affiliate would be required,[100] but subsequently decided that non-structural safeguards would suffice.[101] The particulars of these decisions is not the point here, however. Rather, the key point is that, as reflected in these and other similar court and agency decisions, both sides in these separate affiliate debates, as well as the decisionmakers who resolved them at various points, shared a common assumption about what was fundamentally at stake in such debates, namely, whether the BOCs could provide the competitive service at issue on an end-to-end, physically integrated basis. Thus, for example, in the many years of debate over the wisdom of a separate affiliate requirement for enhanced services, it was uniformly assumed that what was at issue was the BOCs' right to place the design, construction, and operation of the computer facilities necessary to furnish enhanced services -- the computer hardware, the databases, etc. -- in the local operating company and thus to provide such services on an end-to-end, physically integrated basis.

49. In any event, in enacting sections 271 and 272 of the Telecommunications Act of

---

[97] Again, for an exhaustive account of this debate with respect to each of these services, and its resolution by the MFJ court and the FCC at various points in time, see Michael K. Kellog, et al., *Federal Telecommunications Law* (1992 & Supp. 1995).

[98] *See, e.g., In the Matter of an Inquiry into the Use of the Bands 825-845 MHz and 870-890 MHz for Cellular Communications Systems; and Amendment of Parts 2 and 22 of the Commission's Rules Relative to Cellular Communications Systems*, 86 F.C.C.2d 469 at 493 (1981).

[99] *Competitive Carrier Fifth Report and Order*, 98 FCC 2d 1191 (1984) (previous and subsequent history omitted). The *Competitive Carrier Fifth Report and Order* separate affiliate requirement has remained our policy for the last thirteen years, since its adoption.

[100] *See Computer II*, 77 F.C.C.2d at 477-78 (1980); *BOC Separations Order*, 95 F.C.C.2d 1117 (1983).

[101] *See Amendment of Section 64.702 of the Commission's Rules and Regulations* (*Computer III*), CC Docket No. 85-229, Phase I, 104 FCC 2d 958 (1986) (*Phase I Order*), *recon.*, 2 FCC Rcd 3035 (1987) (*Phase I Reconsideration Order*), *further recon.*, 3 FCC Rcd 1135 (1988) (*Phase I Further Reconsideration Order*), *second further recon.*, 4 FCC Rcd 5927 (1989) (*Phase I Second Further Reconsideration Order*); *Phase I Order* and *Phase I Reconsideration Order vacated*, *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990) (*California I*); Phase II, 2 FCC Rcd 3072 (1987) (*Computer III Phase II Order*), *recon.*, 3 FCC Rcd 1150 (1988) (*Phase II Reconsideration Order*), *further recon.*, 4 FCC Rcd 5927 (1989) (*Phase II Further Reconsideration Order*); *Phase II Order vacated*, *California I*, 905 F.2d 1217 (9th Cir. 1990); Computer III Remand Proceeding, 5 FCC Rcd 7719 (1990) (*ONA Remand Order*), *recon.*, 7 FCC Rcd 909 (1992), *pets. for review denied*, *California v. FCC*, 4 F.3d 1505 (9th Cir. 1993) (*California II*); *BOC Safeguards Order*, 6 FCC Rcd 7571 (1991), *vacated in part and remanded*, *California v. FCC*, 39 F.3d 919 (9th Cir. 1994) (*California III*), *cert. denied*, 115 S. Ct. 1427 (1995).

1996, Congress ended the debate with respect to interLATA services and decided the issue legislatively. With respect to in-region interLATA services in particular, the section 271/272 framework permits the BOCs to provide such services once they obtain section 271(d)(3) approval, but they have to do so, at least initially, through a separate affiliate. And as noted above, we are not at liberty to depart from that decision during the period in which the statutory separate affiliate requirements are in effect.

50. The BOCs respond that Congress' decision to impose a separate affiliate requirement did not necessarily include the decision to preclude a BOC from providing in-region interLATA service on a physically integrated basis, that is, from placing the design, construction, and operation of interLATA network facilities in the local network operating company. Rather, in their view, the separate affiliate requirement is designed merely "to make entirely transparent the [wholesale] dealings between an operating company and its interLATA affiliate,"[102] and is entirely agnostic on whether the service ultimately being provided by the BOC to the affiliate and being sold by the affiliate to end users is a uniquely integrated one. Yet, as discussed above, a bar on the integration of a BOC's local facilities and the additional BOC facilities necessary to provide competitive services such as interLATA services has always been understood by courts and agencies, and the lawyers and economists arguing before them, as the *sine qua non* of a separate affiliate requirement, and we presume that Congress chose to impose a separate affiliate requirement in section 272 with that long-held common understanding in mind. And we presume this for good reason. Again as explained above, the concerns for discrimination and improper cost allocation that have always been understood as the justification for the imposition of a separate affiliate requirement are most present where interLATA services are being provided on an integrated basis.[103]

51. Indeed, were we to conclude that the BOCs were permitted to provide interLATA services on an integrated basis, it is hard to understand why Congress would choose to require that a separate affiliate "operate independently" of the BOC, or more importantly, why it would choose to require a separate affiliate at all. To be sure, as the BOCs explain, a separate affiliate also forces the dealings between the operating company and interLATA affiliate to be "entirely transparent." But the only dealings that would take place between the operating company and the separate affiliate under the BOCs' vision of an integrated supplier are the typical dealings that take place between a facilities-based interLATA service provider and a reseller, that is, dealings related to the pricing, ordering, and billing of the facilities-based provider's interLATA services. And the possibility of discrimination in the wholesale

[102] BOCs at 9.

[103] *Cf. Illinois Bell Telephone Company v. FCC*, 883 F.2d 104 (D.C. Cir. 1989) (explaining that "[a]fter the breakup of AT&T, the Commission imposed substantially the same structural separation requirements on the divested BOCs [as on AT&T and its then wholly-owned BOCs], based on the notion that their near-monopoly power in offering network access would give them an unfair advantage in the markets for CPE and enhanced services"). *Id.* at 106.

pricing, ordering, and billing of interLATA services, by itself, has never been thought to justify, so far as we are aware, the imposition of a separate affiliate requirement in an analogous context. It is not surprising, then, that we are also not aware of a separate affiliate requirement in any analogous context, statutory or regulatory, past or present, in which a BOC or similarly regulated entity has been permitted to provide facilities-based integrated service to the separate affiliate, so long as it does not also sell the service to end users.

52. The BOCs also argue that, even assuming that Congress, in enacting section 272, was generally concerned with the risks of discrimination and improper cost allocation that arise with the provision of facilities-based integrated service, such risks are insubstantial in light of the non-discrimination requirement in section 272(e)(4) (even under their reading of it as a grant of authority) that bars a BOC from advantaging its interLATA affiliate. They observe that Congress viewed the risk of discrimination and improper cost allocation as problematic only where the BOCs possess not only the ability to engage in such conduct, but also the *incentive*. In this case, the BOCs argue, the non-discrimination requirement in section 272(e)(4) removes any "conceivable incentive" they might otherwise have to engage in prohibited conduct in the provision of wholesale interLATA services.[104]

53. As an initial matter, we do not think that the presence of a non-discrimination requirement would remove a BOC's incentive to advantage its affiliate, given, among other things, the numerous practical difficulties in enforcing such a requirement.[105] But even assuming *arguendo* that it would diminish the BOC's incentive to some extent, the BOCs' argument here cannot withstand scrutiny. As explained above, in a world in which section 272(e)(4) is a grant of authority, the affiliate would be acting as a reseller that purchases finished wholesale interLATA services from a facilities-based interLATA service provider, i.e., the BOC. Thus, the only incentive the presence of a non-discrimination requirement would diminish is the incentive of the local operating company to discriminate in the pricing, ordering, and billing of wholesale interLATA services in favor of the affiliate. Any benefits of this kind of unlawful conduct could not be captured entirely by the affiliate but would have to be shared. But the non-discrimination requirement certainly would not diminish the local operating company's more serious incentive to discriminate in the internal design, construction, and operation of interLATA networks in favor of itself (concern for which, as just explained, has always been the primary justification for separate affiliate requirements in this area) and at the expense of its rival facilities-based interLATA service providers. Any benefits of this kind of unlawful conduct could be captured entirely by the local operating company when it sells finished wholesale interLATA services to its affiliate and other

[104] *Id.* at 9; *see also* US WEST at 7 (explaining that for a BOC to engage in discrimination or improper cost allocation in these circumstances would be "an irrational strategy").

[105] *See supra* para. 20. For ease of exposition, we focus here only on the significance of the non-discrimination requirement. A similar argument can be made with respect to the cost allocation requirement.

resellers.[106] In this regard, we find it significant that the BOCs claim that "'there is no possibility that a BOC could *use* its supply of wholesale interLATA services to its affiliate to impede competition in the retail market.'"[107] They make no similar claim about the possibility that a BOC could impede competition in the way it *creates* that supply. Thus, because it is clear that, with respect to the design, construction, and operation of interLATA networks, the BOCs have the ability *and* incentive to engage in the very core prohibited conduct that Congress was concerned about when it made its policy choice to require separate affiliates, that choice is controlling.

54. Finally, our conclusion that section 272(e)(4) is not a grant of authority serves as a complete response to the BOCs' arguments regarding use of their in-region, interLATA Official Services Networks. In the *Non-Accounting Safeguards First Report and Order*, we noted that a BOC is permitted to "transfer ownership" of its Official Services Network to its affiliate (so long it did so in a way that gave other carriers an equivalent opportunity to obtain ownership).[108] We did not offer any discussion of the issue, however, because there was no indication in the record before us that transferring ownership of these Networks to affiliates was something that the BOCs seek to do. As a Bell Atlantic affidavit filed in response to our expedited reconsideration of section 272(e)(4) notes, these networks are "currently used in the operation of the local telephone network" and thus their ownership "realistically cannot be transferred."[109] Rather, the BOCs seek to maintain ownership of their interLATA Official Services Networks and lease excess capacity on the networks to their affiliates. The leasing of capacity on an in-region interLATA network is plainly an in-region interLATA service,

---

[106] The following hypothetical scenario might help illuminate this distinction between the incentive to discriminate in the creation of services and the incentive to discriminate in pricing and provisioning them. Suppose that it costs the typical facilities-based interLATA wholesaler 10 cents per minute to create an end-to-end interLATA service (which it then sells, with a markup, to resellers and end users). Suppose also that a BOC, by engaging in discriminatory conduct and improper cost shifting, can design, construct, and operate an integrated interLATA network that enables the BOC to produce the same service at a cost to itself of only 6 cents per minute. With the non-discrimination requirement in place, if the BOC were allowed to provide wholesale interLATA services to its affiliate, it is true that whatever wholesale price it offered to its affiliate would have to be offered to all other carriers and thus the benefits of any unduly low price would have to be shared. But this fact does not mean that the BOC has any less incentive to engage in unlawful discrimination and improper cost allocation in order to be able to produce wholesale interLATA services at a cost of 6 cents per minute. Whatever price it charges to its affiliate and other resellers, the difference between that price and the 6 cents per minute cost is a margin that is retained solely by the BOC. Indeed, because, as just noted, the BOC may have no particular incentive, in light of the non-discrimination requirement, to charge an unduly low price to its affiliate, the difference between that price and the 6 cents per minute could be quite significant. For example, if the BOC charges its affiliate and other resellers 9 cents per minute, the margin is 3 cents per minute and the BOC keeps all of it.

[107] BOCs at 11 (quoting economist's affidavit) (emphasis added).

[108] *Non-Accounting Safeguards First Report and Order*, paras. 218, 266.

[109] BOCs at tab 4, page 2 (Declaration of Hardy F. Moebius, Executive Director in Bell Atlantic's Carrier Services organization).

however.[110] And, as we conclude in this *Second Order on Reconsideration*, because section 272(e)(4) is not a grant of authority, a BOC may not directly provide in-region interLATA services until the separate affiliate requirement is removed.

V. CONCLUSION

55. For the reasons stated, we find that the most sensible interpretation of section 272(e)(4) is that it is a non-discrimination and cost allocation requirement that applies to interLATA services that the BOC is otherwise authorized to provide; it is not an affirmative grant of authority to provide integrated interLATA services on a wholesale basis. In so finding, we emphasize that Congress did not ignore, nor have we, the integrative efficiencies that may result when the same people and facilities of a BOC that provide local service provide interLATA service as well. Indeed, by providing for the sunset of the separate affiliate requirement within three years of BOC entry (for telecommunications services) unless the Commission acts otherwise, Congress envisioned that there may well come a point when the benefits of such efficiencies come to outweigh any risk of anti-competitive harm due to discrimination and improper cost allocation such that consumers are better off. In this respect, the BOCs' emphasis on these benefits is not misguided; it is merely premature.

VI. ORDERING CLAUSES

56. Accordingly, IT IS ORDERED that, pursuant to sections 1-4, 201-205, 214, 251, 252, 271, 272, and 303(r) of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151-154, 201-205, 214, 251, 252, 271, 272, and 303(r), the Second Order on Reconsideration in CC Docket No. 96-149 is ADOPTED.

[110] This conclusion follows from the statutory definition of "interLATA services." 47 U.S.C § 153(21) (defining "interLATA service" as "telecommunications between a point located in a [LATA] and a point located outside such [LATA]"); *id.* § 153(43) (defining "telecommunications" in relevant part as "transmission, between or among points specified by the user, of information of the user's choosing"); *see also id.* § 153(46) (defining "telecommunications service" in relevant part as the "offering of telecommunications for a fee directly to the public"). This conclusion also follows from the fact that, under traditional common carrier law, the ordinary leasing of network facilities is a communications service. *See, e.g., In the Matter of Applications for Authority Pursuant to Section 214 of the Communications Act of 1934 to Cease Providing Dark Fiber Service,* 8 FCC Rcd 2589, 2593 (1993) (finding that even "the provision and maintenance of fiber optic transmission capacity between customer premises where the electronics and other equipment necessary to power or 'light' the fiber are provided by the customer" -- referred to as "dark fiber" -- is a "wire communication," *i.e.*, a communication service, because, among other things, the provider of dark fiber still owns, maintains, and repairs the fiber and merely leases it to the customer for a term of months or years), *remanded on other grounds, Southwestern Bell Telephone Co.* v. *FCC*, 19 F.3d 1475 (D.C. Cir. 1994). By contrast, the one-time transfer of ownership and control of an interLATA network is not an interLATA service, which means it falls entirely outside the section 271/272 framework that governs interLATA services. *See, e.g.*, 47 U.S.C. § 271(a) (neither a BOC nor an affiliate "may provide *interLATA services* except as provided in this section") (emphasis added).

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary